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No. 88-396 (5)

IN THE
Supreme Court of the United States
OCTOBER TERM, 1988

COLONIAL AMERICAN LIFE INSURANCE COMPANY,
Petitioner,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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BRIEF FOR THE PETITIONER

MARGARET MILNER RICHARDSON
(Counsel of Record)
CAROLYN P. CHIECHI
FRANCIS M. GREGORY, JR.
SUTHERLAND, ASBILL & BRENNAN
1275 Pennsylvania Avenue, N.W.
Suite 800
Washington, D.C. 20004-2404
(202) 383-0100
Attorneys for Petitioner

Of Counsel:
JAMES V. HEFFERNAN
GORDON O. PEHRSON, JR.
GEORGE R. ABRAMOWITZ
DOUGLAS N. BECK
SUTHERLAND, ASBILL & BRENNAN

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QUESTION PRESENTED

Whether Colonial American Life Insurance Company, in calculating gain (or loss) from operations under section 809(b) of the Internal Revenue Code, may deduct in the year incurred the ceding commissions it incurred in issuing indemnity reinsurance?

PARTIES TO THE PROCEEDING

Pursuant to Supreme Court Rule 28.1, Colonial American Life Insurance Company has filed with the Court a statement listing all of its parent companies, subsidiaries (except wholly-owned subsidiaries), and affiliates.

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BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the court of appeals (Petitioner's Appendix ("Pet. App.") 1a-9a) is reported at 843 F.2d 201. The opinion of the Tax Court (Pet. App. 11a-22a) is unofficially reported at 51 T.C.M. (CCH) 1123.

JURISDICTION

The judgment of the court of appeals (Pet. App. 9a) was entered on April 26, 1988. A timely filed petition for rehearing was denied on May 25, 1988. (Pet. App. 23a) The petition for a writ of certiorari was filed on August 22, 1988, and was granted on December 5, 1988. The jurisdiction of this Court rests on 28 U.S.C. § 1254(1).

STATUTES AND REGULATIONS INVOLVED

The relevant portions of sections 809, 818, and 162 of the Internal Revenue Code of 1954 (26 U.S.C.),[1] and of section 1.809-4 of the Treasury Regulations on Income Tax (26 C.F.R.), are set out at Pet. App. 25a-38a.

STATEMENT OF THE CASE

A. *The Facts*

During the years in issue, 1975 and 1976, Colonial American Life Insurance Company ("Colonial") was a life insurance company, as defined in section 801(a), engaged in the business of issuing life and accident and health insurance contracts. (Pet. App. 12a) During these years, among the life insurance contracts Colonial issued were four indemnity reinsurance contracts issued to Transport Life Insurance Company ("Transport"). (Pet. App. 14a-15a) It is this insurance which is involved in this case.

Indemnity reinsurance is insurance issued by one insurance company (the reinsurer) to another insurance company (the ceding company) under which the reinsurer indemnifies the ceding company against all or a part of the risks arising out of the insurance policies issued by that ceding company. (Pet. App. 13a, 17a) Under indemnity reinsurance, the ceding company (also sometimes referred to as the "primary" or "direct" insurer) does not relinquish any of its interests in the policies that it issues to the public (so-called "directly-written policies" or "directly-written insurance"). It remains directly liable to its policyholders, who generally have no knowledge of the indemnity reinsurance. (Pet. App. 13a)

[1] Unless otherwise indicated, section references are to the Internal Revenue Code of 1954 (the "Code"), 26 U.S.C., as in effect during the years in issue. Other sections of the Code and the Treasury Regulations discussed herein are set out at Pet. App. 25a-38a.

Under indemnity reinsurance, there is no relationship whatsoever between the reinsurer and the policyholders of the ceding company. The ceding company, as the insurer under the directly-written policies, continues to collect premiums and to pay claims and expenses under such policies. Under indemnity reinsurance, the reinsurer reimburses the ceding company for the claims and expenses such ceding company incurs that are attributable to the risks reinsured. (Pet. App. 13a)

If any of the directly-written policies were to terminate for any reason, the insurance provided by the reinsurer to the ceding company in respect of such policies also would terminate. An indemnity reinsurance contract typically can be terminated by mutual consent of the ceding company and the reinsurer. An indemnity reinsurance contract usually contains a "recapture" provision, under which the ceding company can eliminate the insurance coverage under the indemnity reinsurance with respect to certain risks by "recapturing" such risks. (Tax Court Transcript ("Tr.") 39-40)

Indemnity reinsurance is fundamentally different from assumption reinsurance. (Pet. App. 12a-13a) An assumption reinsurance agreement is the means by which one insurance company purchases or acquires insurance policies from another insurance company. Once the purchase of insurance policies has been effected through an assumption reinsurance agreement, the purchasing company substitutes itself for the selling company and becomes the direct insurer under the policies it acquired. (Stipulation of Facts ("Stip.") ¶ 11a) The purchaser, therefore, assumes all of the liabilities under the policies acquired and becomes directly liable to pay all claims thereunder and all expenses with respect to such policies. (Pet. App. 12a)

Owners of policies which have been purchased by an insurance company pursuant to an assumption reinsurance agreement are issued assumption certificates informing them of the assumption transaction and directing

them to remit any future premium payments to the purchasing company. (Tr. 28) Since an assumption reinsurance transaction is the purchase by one insurance company of the insurance policies of another insurer and does not involve a continuing relationship (insurance or otherwise) between such companies, an assumption reinsurance agreement would never contain a provision allowing the selling company to "recapture" at some future date the insurance policies it sold pursuant to that agreement. (Tr. 40-41)

Under the four indemnity reinsurance contracts involved in this case, Colonial, as the reinsurer, agreed to reinsure certain risks arising out of life insurance policies originally issued by Transport, the ceding company.[2] (Pet. App. 14a-15a; Joint Exhibits ("Jt. Ex.") 4-D, 5-E, 9-I, 10-J) There is no dispute that these four contracts are indemnity reinsurance contracts, not assumption reinsurance agreements. (Tr. 53-57)

Colonial issued two of the indemnity reinsurance contracts in 1975 (Pet. App. 14a) and the other two in 1976. (Pet. App. 15a) Both of the indemnity reinsurance contracts issued in 1976 reinsured risks arising out of the same policies covered by the indemnity reinsurance contracts issued in 1975 and merely increased the percentage (to 6.6 percent under the coinsurance and to 70 percent under the modified coinsurance) of Transport's risks under those policies that Colonial agreed to reinsure. (Pet. App. 15a; Jt. Ex. 4-D, 5-E, 9-I, 10-J)

Each of the indemnity reinsurance contracts provided for Colonial to pay Transport a ceding commission which

[2] Two of the indemnity reinsurance contracts were coinsurance contracts and two were modified coinsurance contracts which the parties had elected, in accordance with section 820, to have treated like coinsurance contracts for tax purposes. Coinsurance and modified coinsurance reinsurance are two of the three principal types of indemnity reinsurance. *United States v. Consumer Life Insurance Co.*, 430 U.S. 725, 746-47 (1977). (Risk premium reinsurance, also known as yearly renewable term reinsurance, is the third principal form of such reinsurance. (Tr. 34))

was negotiated, as is typically done by the parties to an indemnity reinsurance contract. (Pet. App. 15a) In negotiating the pricing of those contracts, essentially the same elements were taken into account as are taken into account in pricing directly-written insurance, *e.g.*, mortality, lapse, and expense (agents' commissions and overhead) assumptions, as well as a projection of future profits anticipated to be realized from the insurance issued. (Tr. 36-39, 50-51; Stip. ¶ 28)

Colonial, as required, filed Annual Statements for 1975 and 1976 with the insurance department of each state in which it was engaged in the life insurance business. (Stip. ¶¶ 16, 23) The form for the Annual Statement and the accounting treatment required to be used therein (sometimes referred to as "NAIC accounting" or "NAIC Annual Statement accounting") are prescribed by the National Association of Insurance Commissioners ("NAIC"). (Stip. ¶ 2)

NAIC accounting treatment for indemnity reinsurance is the same as NAIC accounting treatment for directly-written insurance. (Tr. 47-48) In each case, in calculating its net gain from operations ("Summary of Operations," page 4 of the NAIC Annual Statement), the company issuing the insurance is required to (1) include in premiums (page 4, line 1) the amount of premiums received from its insured, whether the insured is an individual policyholder or an insurance company like Transport, (2) include as part of its deduction for the increase in reserves (page 4, line 17) the reserves required to be established with respect to its liabilities under such insurance, and (3) include as part of its deduction for commissions incurred in issuing insurance (page 4, line 21) the commissions and other expenses incurred in issuing such insurance. (Tr. 33, 41, 48) NAIC accounting precludes a life insurance company from treating commissions and other expenses incurred in issuing indemnity reinsurance or directly-written insurance as cre-

ating or relating to an asset. (Tr. 47) Colonial followed NAIC accounting in its 1975 and 1976 NAIC Annual Statements in reporting the indemnity reinsurance contracts involved here. (Stip. ¶¶ 16, 23; Tr. 43-46)

B. *The Proceedings Below*

For each of the years in issue, in calculating gain (or loss) from operations on its federal income tax returns, Colonial, consistent with NAIC Annual Statement accounting, deducted in the year incurred the ceding commissions it paid to Transport under the indemnity reinsurance contracts in issue. (Stip. ¶ 1)

On audit, the Commissioner of Internal Revenue (the "Commissioner") disallowed Colonial's deductions of those ceding commissions[3] on the theory that such amounts were attributable to the acquisition of an intangible asset with an indeterminate useful life. Alternatively, the Commissioner determined that such amounts were attributable to the cost of acquiring an asset with a determinable useful life and that they must be amortized over the estimated life of that asset.[4] (Pet. App. 15a-16a) Colonial petitioned the Tax Court for a redetermination of the deficiencies determined by the Commissioner.

The Tax Court found that the Code treats indemnity reinsurance as the issuance of insurance by the reinsurer to the primary insurer and held that ceding commissions

[3] Colonial also paid a "finder's fee" in 1975 to a third party in connection with the indemnity reinsurance contracts in issue. That fee was deducted on its 1975 tax return and was disallowed by the Commissioner. (Pet. App. 15a-16a)

[4] The parties stipulated for purposes of this case that if the Tax Court agreed with the Commissioner's determination that the commissions were not deductible in full in the years incurred, the indemnity reinsurance contracts would each be treated as having an estimated useful life of seven years and the ceding commissions could be amortized over that period on a straight-line basis. (Tr. 19)

incurred in issuing indemnity insurance are currently deductible. (Pet. App. 17a-18a)

The Court of Appeals for the Fifth Circuit reversed the Tax Court and held that the ceding commissions incurred by Colonial in issuing the indemnity reinsurance in question are not currently deductible.[5] (Pet. App. 9a)

SUMMARY OF ARGUMENT

This case concerns the federal income tax treatment of ceding commissions incurred by a life insurance company in issuing indemnity reinsurance. That treatment is governed by the rules which Congress prescribed for taxing life insurance companies in Part I of Subchapter L of the Code.[6] These rules treat indemnity reinsurance, consistent with its nature, as the issuance of insurance, *not* as the acquisition of an asset. Thus, the taxing pattern prescribed by Congress in Part I of Subchapter L for taxing life insurance companies with respect to the insurance they issue applies not only to directly-written insurance but also to indemnity reinsurance. *Infra* pp. 10-14.

Under this pattern, premiums received, reserves required, and expenses incurred in connection with the issuance of insurance, whether directly-written insurance or indemnity reinsurance, are taken into account currently. One such expense is the ceding commission in-

[5] The court of appeals held that the same tax treatment applied to the finder's fee. It is Colonial's position that the principles governing the tax treatment of ceding commissions under indemnity reinsurance also control the tax treatment of that fee.

[6] Part I of Subchapter L (sections 801 through 820) was enacted into law by the Life Insurance Company Income Tax Act of 1959, Pub. L. No. 86-69, 73 Stat. 112 ("1959 Act"). Although the provisions of Part I of Subchapter L enacted by the 1959 Act have been amended a number of times, none of the amendments have changed the provisions governing the tax treatment of ceding commissions under indemnity reinsurance.

curred in an indemnity reinsurance transaction. That expense, like the other expenses of issuing insurance, is currently deductible. This result is mandated by section 809(c)(1). The Tax Court, based on a careful analysis of that provision as well as the rest of Part I of Subchapter L, its legislative history, and the regulations, has so held in every case in which it has been presented with this issue (including the case involving Colonial), and the Seventh Circuit recently affirmed the Tax Court in *Merit Life Insurance Co. v. Commissioner*, 853 F.2d 1435 (7th Cir. 1988).[7] *Infra* pp. 21-24.

The premise for the Commissioner's position that ceding commissions incurred under indemnity reinsurance are not currently deductible is the unfounded contention that indemnity reinsurance is "essentially the same in substance" as assumption reinsurance. From that premise, the Commissioner reasons that indemnity reinsurance should not be treated for tax purposes as insurance but, like assumption reinsurance, should be treated as the acquisition of an asset.[8]

The Commissioner's position was accepted by the Fifth Circuit in this case. The Fifth Circuit, relying on the decisions of the Eighth Circuit in *Modern American Life Insurance Co. v. Commissioner*, 830 F.2d 110, *as amended* (8th Cir. 1987), and *Prairie States Life Insurance Co. v. United States*, 828 F.2d 1222 (8th Cir. 1987), failed to recognize that indemnity reinsurance and assumption reinsurance are inherently different. These courts of appeals thus erred in not giving effect to the tax treatment mandated for ceding commissions incurred in indemnity reinsurance transactions by Part I

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[7] On December 8, 1988, the Solicitor General petitioned this Court for a writ of certiorari to the Seventh Circuit in *Merit Life*.

[8] *See, e.g.*, Brief for the Commissioner to the Fifth Circuit in this case, p. 47.

of Subchapter L, its legislative history, and the regulations. *Infra* pp. 14-26.

In contrast to indemnity reinsurance, an assumption reinsurance agreement effects the acquisition of insurance policies by one insurance company from another insurer and is so treated for federal income tax purposes. Thus, the federal income tax treatment of the commissions incurred in each type of transaction is different. In the case of indemnity reinsurance (as well as directly-written insurance), the commission is an expense incurred by an insurance company in issuing insurance and therefore is currently deductible. In the case of assumption reinsurance, the commission is the purchase price paid by an insurance company to acquire insurance policies and therefore must be amortized over the estimated life of those policies. *Infra* pp. 14-26.

The manner in which ceding commissions under indemnity reinsurance are required to be treated in determining gain (or loss) from operations under section 809(b) is consistent with the manner in which such commissions are required to be treated in determining net gain from operations under NAIC accounting. This is not surprising, since the rules Congress provided in Part I governing the taxation of life insurance companies were based on NAIC Annual Statement accounting practices. Pursuant to section 818(a), as interpreted by this Court, "except when the rules of accrual accounting dictate a contrary result, NAIC procedures 'shall' apply" for federal income tax purposes. *Commissioner v. Standard Life & Accident Insurance Co.*, 433 U.S. 148, 159 (1977). The rules of accrual accounting do not dictate a result contrary to NAIC accounting in the present case. *Infra* pp. 26-30.

ARGUMENT

COLONIAL IS ENTITLED TO DEDUCT CURRENTLY THE CEDING COMMISSIONS IT INCURRED IN ISSUING INDEMNITY REINSURANCE

A. Indemnity Reinsurance Is Insurance And Is Treated By The Code As Insurance

Indemnity reinsurance is insurance which is issued by one insurance company (the reinsurer) to another insurance company (the ceding company),[9] a fact that Congress was fully aware of when it wrote the 1959 Act. Consistently, Congress treated indemnity reinsurance[10] as insurance in Part I of Subchapter L, and *not* as the acquisition of an asset. Thus, in discussing indemnity reinsurance under the taxing pattern prescribed in the 1959 Act,[11] the Senate Finance Committee stated:

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[9] *See, e.g.*, W. W. Steffen, "Reinsurance," in *Life and Health Insurance Handbook*, at 991 (D.W. Gregg & V.B. Lucas, 3d ed. 1973) ("Reinsurance is an insurance agreement or contract under which one insurer, often called the *ceding company*, is indemnified against loss by another insurer, called the *reinsurer*, arising out of an insurance policy written by the original insurer. Thus, a reinsurance contract is a separate insurance agreement and presupposes the existence of an original policy.") (Emphasis included; footnote omitted.); H.T. Kramer, "The Nature of Reinsurance," in *Reinsurance*, at 4 (R. Strain 1980) ("Reinsurance is a form of insurance. As such, a contract of reinsurance is an insurance contract.").

[10] Indemnity reinsurance is sometimes referred to in the Code and the regulations as "reinsurance ceded." *E.g.*, section 809(c)(1); Treas. Reg. § 1.809-4(a)(1)(ii). The regulations make it clear that the term "reinsurance ceded" includes indemnity reinsurance, but not assumption reinsurance. *E.g.*, Treas. Reg. § 1.809-4(a)(1)(iii).

[11] Although the 1959 Act established a three-phase pattern for determining a life insurance company's taxable income, only phase two, the calculation of gain (or loss) from operations under section 809(b), is involved in this case. *See United States v. Atlas Life Insurance Co.*, 381 U.S. 233, 235 n.2 (1965), which describes more fully the pattern for the taxation of life insurance companies. "Gain from Operations" is defined in section 809(b)(1) as that

> Three forms of this indemnity reinsurance have been developed. The first of these, called coinsurance, calls for the premium with respect to the insurance reinsured to go to the reinsurer, with the result that the reinsurer, with respect to this insurance, is treated substantially in the manner he would be if he had issued the insurance policy (or part thereof) directly. Any expenses incurred by the primary insurer with respect to the policy are reimbursed by the reinsurer. This form of indemnity reinsurance presents few special tax problems.

S. Rep. No. 291, 86th Cong., 1st Sess. 38-39, *reprinted in* 1959 U.S. Code Cong. & Admin. News 1575, 1613-14.

The courts have recognized on numerous occasions that indemnity reinsurance is insurance and is so treated by the Code. *E.g.*, *Merit Life*, 853 F.2d at 1442 ("[b]ecause substantively indemnity reinsurance is the sale of insurance . . . it follows that, in addition to the explicit provisions of the Code and treasury regulations, the principles governing the sale of insurance . . . also apply to indemnity reinsurers"); *Cologne Life Reinsurance Co. v. Commissioner*, 80 T.C. 859, 862 (1983) ("[u]nder these sections [801-820], the issuance of indemnity life reinsurance is treated generally as the issuance of life insurance"), *aff'd by summary order*, 732 F.2d 141 (2d Cir. 1984) (unpublished opinion); *Beneficial Life Insurance Co. v. Commissioner*, 79 T.C. 627, 646 (1982) ("indemnity reinsurance . . . is treated as the ceding company's purchase of insurance"). *See also Oxford Life Insurance Co. v. United States*, 790 F.2d 1370, 1376 (9th Cir. 1986) ("an indemnity reinsurance transaction is the purchase of insurance protection [by] the reinsured").

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amount by which certain items of income described in section 809(b)(1), which include the gross amount of premiums under section 809(c)(1), exceed the deductions provided by section 809(d). "Loss from Operations" is defined in section 809(b)(2) as the amount by which the deductions provided by section 809(d) exceed the items of income described in section 809(b)(2), which are the same items of income described in section 809(b)(1).

The rules prescribed in Part I of Subchapter L for determining how life insurance companies are taxed with respect to the insurance they issue generally draw no distinctions between directly-written insurance and the form of insurance known as indemnity reinsurance. Thus, the provisions of Part I apply as written to indemnity reinsurance,[12] except where indemnity reinsurance has been specifically excluded from the application of certain Code sections.[13]

In fact, the Commissioner has taken issue with this point in one respect only. The Commissioner did not challenge any item of income under section 809(b)(1), or any item of deduction under section 809(d), which was taken into account by Colonial in respect of the indemnity reinsurance in question, except one—the expenses incurred in issuing such reinsurance. Therefore, what the Commissioner has asked the courts to do, and what the Fifth Circuit did, is to treat indemnity reinsurance like directly-written insurance in all respects ex-

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[12] *See, e.g.*, section 801(a) of the Code, defining the term "life insurance company" to mean an insurance company which is engaged in the business of issuing life insurance and annuity contracts (provided certain requirements are met); section 809(d)(1), providing a deduction for all claims and benefits accrued and all losses incurred during the year on insurance and annuity contracts. Although neither section refers specifically to indemnity reinsurance, it is undisputed that each covers such reinsurance.

[13] When it chose to do so, Congress expressly excluded indemnity reinsurance from the application of certain Code sections. *See, e.g.*, section 806(a) and section 809(d)(7). Moreover, when it chose to do so, Congress expressly provided special rules for the treatment of indemnity reinsurance. *See* section 820 which prescribed special rules for the type of indemnity reinsurance known as modified coinsurance because Congress was concerned that, absent those special rules, such reinsurance might have special tax problems under the rules Congress had otherwise prescribed in Part I of Subchapter L. S. Rep. No. 291, *supra*, at 39, 1959 U.S. Code Cong. & Admin. News at 1614; *see also Consumer Life*, 430 U.S. at 747-48.

cept one, namely, the expenses incurred by life insurance companies in issuing such reinsurance.[14]

The Commissioner's request to pick and choose among Code provisions and to treat indemnity reinsurance as insurance for some purposes, but not for purposes of determining the proper tax treatment of expenses incurred in issuing indemnity reinsurance, is totally unfounded. It has been repeatedly rejected by the Tax Court [15] whose special expertise in technical tax matters warrants deference.[16] It has also been rejected by the Seventh Circuit which affirmed the Tax Court in *Merit Life*. There is no basis in Part I of Subchapter L to treat an issuer of

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[14] It was not until over 20 years after the passage of the 1959 Act that the Commissioner first announced, in Rev. Rul. 82-69, 1982-1 C.B. 102, the official position of the Internal Revenue Service that ceding commissions under indemnity reinsurance are not currently deductible. Prior to that time, the Commissioner's published position on the tax treatment of such commissions was set forth in Rev. Rul. 70-552, 1970-2 C.B. 141. This ruling held that—

> the taxpayer is entitled to a deduction for commission expense equal to the amount of the ceding commission due the primary insurer as an ordinary and necessary business expense incurred . . . in the taxable year in which the reinsurance coverage becomes effective.

Although Rev. Rul. 70-552 involved an insurance company taxed under Part III of Subchapter L of the Code, its holding is equally applicable to insurance companies taxed under Part I.

[15] *Beneficial Life*, 79 T.C. at 647-48; *Merit Life Insurance Co. v. Commissioner*, 52 T.C.M. (CCH) 658, 660 (1986), *aff'd*, 853 F.2d 1435 (7th Cir. 1988); *Colonial American Life Insurance Co. v. Commissioner*, 51 T.C.M. (CCH) 1123, 1126 (1986), *rev'd*, 843 F.2d 201 (5th Cir. 1988); *Individual Life Assurance Co. v. Commissioner*, 51 T.C.M. (CCH) 1028, 1030 (1986) (revised per memorandum sur order (Oct. 8, 1977) because appeal would be to the Eighth Circuit); *Modern Security Life Insurance Co. v. Commissioner*, 51 T.C.M. (CCH) 188, 189-90 (1985), *rev'd sub nom. Modern American Life Insurance Co. v. Commissioner*, 830 F.2d 110, *as amended* (8th Cir. 1987).

[16] *Dobson v. Commissioner*, 320 U.S. 489, 502 (1943).

insurance to other insurance companies differently from an issuer of insurance to the public with respect to the expenses each incurs in issuing its insurance.[17]

B. Indemnity Reinsurance Is Inherently Different From Assumption Reinsurance And Is Treated By The Code Differently From Assumption Reinsurance

In adopting the position of the Commissioner in this case, the Fifth Circuit concluded that it found no "clear difference in the statute [Code] for treatment of assumption reinsurance contracts and indemnity reinsurance contracts" and that therefore a " 'general' tax rule" must be applied. *Colonial American Life Insurance Co. v. Commissioner*, 843 F.2d 201, 204 (5th Cir. 1988).[18] Under the "general" tax rule advanced by the Commissioner, expenses incurred to acquire an asset must be amortized over the expected life of the asset. The Fifth Circuit held that, under this "general" tax rule, the ceding commissions incurred by Colonial in issuing the indemnity reinsurance in question "must be depreciated or amortized over the useful life of the interest acquired." *Id.* at 205.

The premise for this holding is that the Code treats indemnity reinsurance as the acquisition of an asset, *not* as insurance. That premise is wrong: it reflects a misunderstanding of the nature of indemnity reinsurance as

[17] If the Commissioner's position were upheld, those insurers known as professional reinsurers, the principal or exclusive insurance business of which is the issuance of indemnity reinsurance, would be treated differently for purposes of Part I of Subchapter L from those companies issuing only directly-written insurance. This would clearly be contrary to congressional intent. *See* the Senate Finance Committee Report quoted *supra* p. 11.

[18] In holding for the Commissioner, the Fifth Circuit embraced the Eighth Circuit's reasoning in *Modern American* and *Prairie States*. As demonstrated below, the Eighth Circuit's reasoning, which the Fifth Circuit adopted, is flawed.

contrasted to assumption reinsurance, as well as a misunderstanding and misinterpretation of Part I of Subchapter L.[19]

The essence of indemnity reinsurance is that one insurance company (the reinsurer) agrees to reinsure the risks arising out of another company's (the ceding company's) insurance policies, thereby creating an insurance relationship between those insurance companies, but establishing no relationship (insurance or otherwise) between the reinsurer and the policyholders of the ceding company.

In contrast, the essence of an assumption reinsurance transaction is that it effects the purchase by one insurance company of the insurance policies of another insurance company, thereby substituting the purchasing company for the selling company as the direct insurer under the policies purchased, but creating no continuing relationship (insurance or otherwise) between the two insurance company parties to the transaction.[20]

Indemnity reinsurance therefore is fundamentally different from assumption reinsurance.[21] This was recognized not only by the Tax Court, but also by the Seventh Circuit in *Merit Life*. The court of appeals stated:

> From the reinsuring company's perspective, indemnity reinsurance is not an acquisition of an intang-

[19] *Merit Life*, 853 F.2d at 1440-42. *See* cases cited *supra* note 15; *see also Oxford Life*, 790 F.2d at 1376.

[20] Indeed, the use of the word "reinsurance," when referring to an assumption transaction, is somewhat misleading, since such a transaction is really the means by which one insurance company purchases insurance policies from another insurance company.

[21] The characteristics of indemnity reinsurance and of assumption reinsurance, which illustrate the fundamental differences between those two types of transactions, are described in detail in the Statement of the Case, *supra* pp. 2-4.

ible asset with a useful life of more than one year. By its nature, an indemnity reinsurance transaction is, from the perspective of the reinsurer, simply an indemnity or co-insurance arrangement, in substance, the sale of an insurance policy by the reinsurer to the ceding company. Economically, it is substantially the same as the sale of any other policy. In contrast, assumption reinsurance is by its nature the purchase of already issued insurance policies and the elimination of any participation or interest of the selling or ceding company.

853 F.2d at 1441. *See also* cases cited *supra* note 15.

In recognition of the basic differences between indemnity reinsurance and assumption reinsurance, Congress drew distinctions between them in Part I of Subchapter L of the Code. For example, sections 806(a) and 809(d)(7) specifically apply only to assumption reinsurance and specifically exclude indemnity reinsurance from their application.[22]

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[22] Section 806(a) provides:

> For purposes of this part, if, during the taxable year, there is a change in life insurance reserves attributable to the transfer between the taxpayer and another person of liabilities under contracts taken into account in computing such reserves, then, under regulations prescribed by the Secretary, the means of such reserves, and the mean of the assets, shall be appropriately adjusted, on a daily basis, to reflect the amounts involved in such transfer. *This subsection shall not apply to reinsurance ceded to the taxpayer or to another person.*

(Emphasis added.)

Section 809(d)(7) allows a company that sells its insurance policies to another insurance company in an assumption reinsurance transaction a deduction for—

> [t]he consideration (*other than consideration arising out of reinsurance ceded*) in respect of the assumption by another person of liabilities under insurance and annuity contracts (including contracts supplementary thereto).

(Emphasis added.)

The legislative history of the 1959 Act confirms congressional recognition of the fundamental differences between indemnity reinsurance and assumption reinsurance and congressional intent to treat indemnity reinsurance and assumption reinsurance differently for tax purposes. Thus, in discussing the nature of indemnity reinsurance and the fact that it presented "few special tax problems" under the 1959 Act, the Senate Finance Committee contrasted indemnity reinsurance with assumption reinsurance, stating:

> Modified coinsurance is a form of indemnity reinsurance (*as contrasted to assumption reinsurance*) to indemnify an insurer against a risk it has assumed. Hence, *as distinct from assumption reinsurance*, the initial risk in this case remains with the insurer but he covers this risk by reinsuring part or all of a contract with another insurance company (referred to here as the reinsurer).

S. Rep. No. 291, *supra*, at 38, 1959 U.S. Code Cong. & Admin. News at 1613. (Emphasis added.)

The legislative history of the Deficit Reduction Act of 1984 ("DEFRA") reaffirmed these principles in connection with the revisions made by Congress to Part I of Subchapter L:

> *The Code distinguishes between indemnity reinsurance (or reinsurance ceded) and assumption reinsurance.* The first is an arrangement whereby the ceding company remains solely liable to the policyholder, whether all or only a portion of the risk has been transferred to the reinsurer. The second is an arrangement whereby another person (the reinsurer) becomes solely liable to the policyholders on the contracts transferred by the ceding company. *Whereas an indemnity reinsurance contract describes a continuing insurance relationship between the ceding company and the reinsurer, an assumption reinsurance contract is considered a sale of a block of business.*

Staff of the Joint Comm. on Taxation, 98th Cong., 2nd Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 633 (Comm. Print 1984) (hereinafter "General Explanation"). (Emphasis added.) *See also* LTR 8742004 (June 30, 1987), where the Commissioner stated this explanation almost verbatim in a Technical Advice Memorandum issued just prior to his appeal to the Seventh Circuit in the *Merit Life* case.

Consistent with the Code and its legislative history, the Treasury Department and the Internal Revenue Service have also differentiated between indemnity reinsurance and assumption reinsurance in the regulations issued after the 1959 Act became law. Thus, for example, in defining indemnity reinsurance ("reinsurance ceded"), the regulations make it clear that the term does *not* include assumption reinsurance.[23] Consistently, in defining assumption reinsurance, the regulations make it clear that the term does *not* include indemnity reinsurance.[24]

The Treasury Department and the Internal Revenue Service have promulgated regulations under specific Code

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[23] Treas. Reg. § 1.809-4(a)(1)(iii) states—

> For purposes of section 809(c)(1) and this subparagraph, the term "reinsurance ceded" means an arrangement whereby the taxpayer (the reinsured) remains solely liable to the policyholder, whether all or only a portion of the risk has been transferred to the reinsurer. *Such term includes indemnity reinsurance transactions but does not include assumption reinsurance transactions.*

(Emphasis added.)

[24] Treas. Reg. § 1.809-5(a)(7)(ii) states—

> For purposes of section 809(d)(7) and this subparagraph, the term "assumption reinsurance" means an arrangement whereby another person (the reinsurer) becomes solely liable to the policyholders on the contracts transferred by the taxpayer. *Such term does not include indemnity reinsurance or reinsurance ceded (as defined in paragraph (a)(1)(iii) of § 1.809-4).*

(Emphasis added.)

sections in Part I of Subchapter L, which apply *only* to assumption reinsurance transactions. One of these regulations is Treas. Reg. § 1.817-4(d).[26] That regulation, which, by its terms, applies *solely* to assumption reinsurance, *not* to indemnity reinsurance, prescribes the tax treatment of assumption reinsurance transactions.[26] Subsection (2)(ii) of Treas. Reg. § 1.817-4(d) specifically addresses ceding commissions and requires the amortization, rather than the current deduction, of such commissions *only* in the case of assumption reinsurance, *not* in the case of indemnity reinsurance.[27]

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[25] *See also* Treas. Reg. §§ 1.806-3(a) and 1.809-5(a)(7), which implement sections 806(a) and 809(d)(7), and apply solely to assumption reinsurance, not to indemnity reinsurance. *See supra* note 22.

[26] Treas. Reg. § 1.817-4(d), which relates solely to assumption reinsurance transactions after 1958, was issued as a regulation under section 817 (captioned "Rules Relating to Certain Gains and Losses"), which generally involved gains and losses on the sale or exchange of property by a life insurance company. Section 817(e) (as enacted by the 1959 Act) provided that any assumption reinsurance transaction occurring *in 1958* was to be treated as a sale of a capital asset by the insurance company selling its insurance policies to another insurer. Since, under section 817(d) (as enacted by the 1959 Act), capital gains of life insurance companies from sales or exchanges of property occurring prior to 1959 were excluded from income, the gain to the selling company from an assumption reinsurance transaction occurring before 1959 was not subject to tax. Treas. Reg. § 1.817-4(d) was promulgated to clarify that gain to a selling company from an assumption reinsurance transaction occurring *after 1958* was not to be accorded favorable capital gain treatment, although such a transaction was still to be treated as a sale of insurance policies by one company to another insurer. There has never been any suggestion of which Colonial is aware that an indemnity reinsurance transaction, whether occurring before, during, or after 1958, is to be treated as a *sale of property by the ceding company.*

[27] Treas. Reg. § 1.817-4(d)(2)(ii) states—

> *In connection with an assumption reinsurance (as defined in paragraph (a)(7)(ii) of § 1.809-5) transaction,* a reinsurer shall in any taxable year beginning after December 31, 1957:

Despite the clear and unambiguous language of this regulation, the Fifth Circuit, as well as the Eighth Circuit cases on which it relied, concluded that the "principles" behind Treas. Reg. § 1.817-4(d)(2)(ii) which controls the treatment of amounts paid by the assuming company in an assumption reinsurance transaction should also control the tax treatment of ceding commissions in indemnity reinsurance. *See Colonial American Life*, 843 F.2d at 205; *Prairie States Life*, 828 F.2d at 1233-34; *Modern American Life*, 830 F.2d at 113-14. In so concluding, these courts of appeals did not explain why, in drafting Treas. Reg. § 1.817-4(d), the Treasury Department and the Internal Revenue Service expressly limited the application of that regulation *solely* to assumption reinsurance. The only logical answer is that the regulation, and the "principles" underlying it, apply *only* to assumption reinsurance and *not* to indemnity reinsurance because, unlike assumption reinsurance which is treated by the Code as the acquisition of an asset, indemnity reinsurance is treated by the Code as insurance.

Thus, as the Seventh Circuit correctly concluded in *Merit Life*, 853 F.2d at 1442:

> Because substantively indemnity reinsurance is the sale of insurance by the reinsurer to the ceding company, it follows that, in addition to explicit provi-

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> (A) Treat the consideration received from the reinsured in any such taxable year as an item of gross amount under section 809(c)(1), and
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> (B) Treat any amount paid to the reinsured for the purchase of such contracts, to the extent such amount meets the requirements of section 162, as a deferred expense that may be amortized over the reasonably estimated life (as defined in paragraph (d)(2)(iv) of this section) of the contracts reinsured and treat the portion of the expense so amortized in each taxable year as a deduction under section 809(d)(12) irrespective of the taxable year in which such amount was pa'd to the reinsured.

(Emphasis added.)

> sions of the Code and treasury regulations, the principles governing the sale of insurance, in the case of direct insurers, also apply to indemnity reinsurers.

These principles require that, in calculating gain (or loss) from operations under section 809(b), expenses incurred in issuing directly-written insurance be deducted currently and also require that expenses incurred in issuing indemnity reinsurance be deducted currently. *Infra* pp. 21-30.

C. Ceding Commissions Under Indemnity Reinsurance Are Analogous To Currently Deductible Underwriting Expenses Incurred By Primary Insurers And Are Currently Deductible

Ceding commissions incurred by a life insurance company in issuing indemnity reinsurance are analogous to agents' commissions and other expenses incurred by a life insurance company in issuing directly-written insurance. *See Colonial Surety Co. v. United States*, 178 F. Supp. 600, 602 (Ct. Cl. 1959). In each case, such expenses are incurred by the issuing compa..y in selling its insurance.[28] This has been recognized by various courts. *See Merit Life, supra*, at 1441-45; *Beneficial Life*, 79 T.C. at 645-47; *Modern Security Life*, 51 T.C.M. (CCH)

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[28] A ceding commission under indemnity reinsurance is a negotiated amount which may be calculated to take into account, *inter alia*, the ceding company's costs of issuing the insurance which is reinsured and which may also contain a profit element for the ceding company. (Tr. 36-39) *See Consumer Life*, 430 U.S. at 746, where this Court recognized that a ceding commission under indemnity reinsurance is intended "to cover the insurer's overhead." Similarly, a principal component of a direct writer's initial costs in issuing insurance is the commissions which it pays to its agents for "insurance placement services" and which also contain a profit element for such agents. *See, e.g.*, "Glossary" in *Reinsurance*, at 648 (R. Strain 1980). In both cases, the expenses are incurred with the expectation that a profit will be realized from the insurance issued. (Tr. 39-40, 51) That expectation is not necessarily realized. *See infra* note 34.

at 189; *Individual Life*, 51 T.C.M. (CCH) at 1029-30; *Colonial American Life*, 51 T.C.M. (CCH) at 1126. *See Oxford Life*, 790 F.2d at 1376.

The Tax Court has repeatedly held that ceding commissions under indemnity reinsurance are deductible as return premiums in the year incurred under section 809(c)(1).[20] That position was affirmed in *Merit Life*. The Tax Court has also concluded that ceding commissions under indemnity reinsurance are "analogous to currently deductible underwriting expenses" of primary insurers. *See, e.g., Beneficial Life, supra*, at 647. The Seventh Circuit, in *Merit Life, supra*, at 1444-45, agreed with this analogy. Since such expenses of primary insurers are indisputably part of "Other Deductions" under section 809(d)(12), the Tax Court (and the Seventh Circuit) also could have properly held that ceding commissions in indemnity reinsurance transactions are currently deductible as part of such "Other Deductions." The result for the reinsurer in calculating gain (or loss) from operations under section 809(b) is the same under either approach.

1. *Section 809(c)(1)*

Section 809(c)(1) and the regulations thereunder control the tax treatment of ceding commissions under indemnity reinsurance. Section 809(c)(1) provides that "return premiums" as well as "premiums and other consideration arising out of reinsurance ceded" are deducted from the gross amount of premiums determined thereunder.

Section 1.809-4(a)(1)(ii) of the Treasury Regulations requires that "amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded shall be included in return premiums." Ceding commissions under indemnity reinsurance are "amounts of premiums or other consideration returned

[20] *Supra* note 15.

to another life insurance company in respect of reinsurance ceded." Accordingly, such commissions are included in return premiums and are therefore currently deductible in computing premium income under section 809(c)(1). *Merit Life, supra*, at 1439-40; *Beneficial Life, supra*, at 646-48; *Modern Security Life, supra*, at 189-90; *Individual Life, supra*, at 1030; *Colonial American Life, supra*, at 1127-28. *See Oxford Life, supra*, at 1376.[20]

Despite the clear and unambiguous language of the statute and the regulations, the Commissioner argued below that they could not possibly mean what they say. Specifically, the Commissioner contended that the phrase "less return premiums, and premiums and other consideration arising out of reinsurance ceded," which appears in section 809(c)(1), serves "to reduce the premium income of the primary insurer (the ceding company) —not that of the reinsurer."[21] That assertion is totally unfounded. *Merit Life, supra*, at 1439.

There is no question under the plain language of the statute, the regulations, or the legislative history[22] that

[20] In *Oxford Life*, the Court of Appeals for the Ninth Circuit addressed the issue of the tax treatment of ceding commissions under assumption reinsurance. Citing with approval the Tax Court's *Beneficial Life* opinion, the Ninth Circuit concluded that indemnity reinsurance and assumption reinsurance are treated differently by the Code and that, unlike assumption reinsurance where the initial ceding commission must be amortized over the life of the block of policies acquired, indemnity reinsurance is treated by the Code as the issuance of insurance by the reinsurer to the ceding company and therefore the reinsurer is entitled to reduce its premiums under section 809(c)(1) by the initial ceding commission it pays to the ceding company. 790 F.2d at 1376.

[21] Brief for the Commissioner to the Fifth Circuit in this case, p. 42.

[22] *See* S. Rep. No. 291, *supra*, at 21, 54, 1959 U.S. Code Cong. & Admin. News at 1595, 1629.

an indemnity reinsurer must include in premiums under section 809(c)(1) the premiums received from the ceding company to which it issues indemnity reinsurance. Nor is there any question under that language that "return premiums" as well as "premiums and other consideration arising out of reinsurance ceded" are deducted from such premiums under section 809(c)(1). If, as the Commissioner contended, Congress had intended to limit the deduction from premiums provided by section 809(c)(1) to premiums received only by primary insurers, and not indemnity reinsurers, it would have so stated. Judge Frank perhaps said it best:

> A short sentence would have done the trick. The familiar "easy-to-say-so-if-that-is-what-was-meant" rule of statutory interpretation has full force here. The silence of Congress is strident.

Commissioner v. Beck's Estate, 129 F.2d 243, 245 (2d Cir. 1942). (Footnote citation omitted.) The Commissioner has not been given authority to rewrite the law by disregarding its plain language. *See, e.g., Lewyt Corp. v. Commissioner*, 349 U.S. 237, 240 (1955); *Unexcelled Chemical Corp. v. United States*, 345 U.S. 59, 63-64 (1953).

2. *Section 809(d)(12)*

Section 809(d)(12) permits a deduction for "all other deductions allowed under this subtitle for purposes of computing taxable income to the extent not allowed as deductions in computing investment yield." Thus, "ordinary and necessary" business expenses described in section 162(a) are deductible by a life insurance company under section 809(d)(12). It is beyond question that commissions and other expenses of primary insurers in issuing directly-written insurance are currently deductible under section 809(d)(12), by virtue of their being "ordinary and necessary" business expenses under section 162(a). This is true even though such commissions and other expenses "arguably might be classified as acquisition expenses to be amortized."[33] This is also true of commissions and other expenses incurred in issuing indemnity reinsurance even though the reinsurer, like the primary insurer, expects to realize a profit from the insurance it issues.[34]

Under Part I of Subchapter L, there is no distinction between directly-written insurance and indemnity reinsurance; each is treated as insurance by the Code. Nor does the pattern for taxing life insurance companies prescribed by the Code distinguish between the expenses of issuing directly-written insurance and the expenses of issuing indemnity reinsurance. In each case, the Code allows a life insurance company, in computing gain (or loss) from operations under section 809(b), to reduce currently its underwriting income by the expenses in-

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[33] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1428, *reprinted in* 1984 U.S. Code Cong. & Admin. News 697, 1073; S. Prt. No. 169 (Vol. I), 98th Cong., 2d Sess. 555 (1984). The House Committee on Ways and Means and the Senate Committee on Finance each restated this rule of Part I of Subchapter L when Congress enacted provisions in DEFRA that changed (effective 1984) certain sections of the Code which had been enacted as part of the 1959 Act:

> The change [DEFRA] from present law [1959 Act] was intended to reinforce the primacy of the Federal tax rules and not impose a new method of tax accounting on life insurance companies. *Thus, for example, agents' commissions paid by direct insurers would continue to be treated as sales expenses and deductible when paid, as has been allowed historically (even though they arguably might be classified as acquisition expenses to be amortized).*

Id. (Emphasis added.) *See also* General Explanation, *supra*, at 621.

[34] Of course, even though a primary insurer or an indemnity reinsurer may *expect* to realize a profit from the insurance each issues, this does not mean that each will in fact realize a profit. To the contrary, each may realize a loss.

curred in issuing such insurance.[35] This result is precisely what Congress envisioned when it passed the 1959 Act.[36]

D. NAIC Accounting, Which Requires That Ceding Commissions Under Indemnity Reinsurance Be Deducted Currently, Is Controlling For Tax Purposes

The rules Congress provided in the 1959 Act for taxing life insurance companies were based on the Annual Statement accounting prescribed for life insurance companies by the National Association of Insurance Commissioners. Section 818(a).[37] In enacting Part I of Sub-

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[35] *See Merit Life*, 853 F.2d at 1438-40, 1443-45; cases cited *supra* note 15. *See also Oxford Life*, 790 F.2d at 1376.

[36] H.R. Rep. No. 34, 86th Cong., 1st Sess. 3-4, *reprinted in* 1959-2 C.B. 736, 738; S. Rep. No. 291, *supra*, at 6-7, 38-39, 1959 U.S. Code Cong. & Admin. News at 1581-82, 1613-14. Thus, Congressman Wilbur Mills, in discussing the 1959 Act on the floor of the House of Representatives, stated:

> [T]ypically life insurance companies show a loss from operation in their early years by charging off as an expense in those years many of the costs associated with income that will be received in later years. 105 Cong. Rec. 10412 (1959).

See also H.R. Rep. No. 34, *supra*, at 4, 1959-2 C.B. at 738 ("Many small, new and growing life insurance companies have underwriting losses rather than gains because of the additional initial costs they incur (such as agents' commissions) in placing the new policies on their books."); S. Rep. No. 291, *supra*, at 7, 1959 U.S. Code Cong. & Admin. News at 1582 ("The small, new, and growing life insurance companies are particularly likely to have underwriting losses because of the initial costs which they incur (such as agents' commissions) in placing new policies on their books.").

[37] Section 818(a) provides—

> (a) All computations entering into the determination of the taxes imposed by this part shall be made—
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> (1) under an accrual method of accounting, or
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> (2) to the extent permitted under regulations prescribed by the Secretary or his delegate, under a combination of an accrual method of accounting with any other method permitted by this chapter (other than the cash receipts and disbursements method).
>
> *Except as provided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.*

(Emphasis added.)

chapter L, Congress intended that the net gain from operations reflected in the Annual Statement in the "Summary of Operations" be the starting point for calculating gain (or loss) from operations for federal tax purposes.[38] "Gain from operations" is a term of art which appears outside of section 809(b) only in NAIC accounting and is clearly derived from the page of the Annual Statement designated "Summary of Operations."[39]

When Congress enacted Part I of Subchapter L, it was fully aware of NAIC Annual Statement accounting practices, including the NAIC requirement that, in calculating net gain from operations, commissions incurred in issuing insurance, both directly-written insurance and

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[38] For example, the Secretary of the Treasury wrote Congress:

> We suggest that the starting point for measuring the net earnings should be the figure for "Net gain from operations after dividends to policyholders" which appears in each company's annual statement to the State insurance departments and which summarizes the operating results for the year. *This figure is based on carefully developed life insurance accounting practices which have general acceptance in the industry.*

Taxation of Income of Life Insurance Companies: Hearings Before the Subcomm. on Internal Revenue Taxation of the House Comm. on Ways and Means, 85th Cong., 2d Sess. 4 (1958); Tax Formula for Life Insurance Companies: Hearings on H.R. 4245 Before the Senate Comm. on Finance, 86th Cong., 1st Sess. 512 (1959) (Statement of Robert B. Anderson, Secretary of the Treasury). (Emphasis added.)

[39] Net gain from operations was first reflected in the Annual Statement (page 4) in the "Summary of Operations" in 1951.

indemnity reinsurance, be deducted currently.[40] Although the final language of Part I of Subchapter L reflected a number of specific modifications of net gain from operations as shown in the NAIC Annual Statement, disallowing a current deduction for commissions on indemnity reinsurance in determining gain (or loss) from operations under section 809(b) was *not* among these specific modifications. Since there is no provision in Part I of Subchapter L requiring deviation for federal tax purposes from the manner in which such commissions are taken into account in the computation of net gain from operations in the Annual Statement, it is reasonable to conclude that Congress intended the NAIC accounting approach to be followed for purposes of calculating gain (or loss) from operations under section 809(b).[41] Any other conclusion would be contrary to section 818(a).

Section 818(a) has been interpreted by this Court to require use of NAIC accounting "except when the rules of accrual accounting dictate a contrary result . . . ." *Standard Life*, 433 U.S. at 159. There are no rules of accrual accounting which dictate a result contrary to NAIC accounting in the present case. The rules of accrual accounting do not speak to the question of the character, as a currently deductible expense or as an amortizable capital expenditure, of the ceding commission a company incurs in issuing the form of insurance

[40] Since 1951, the current deduction of commissions incurred in issuing insurance, both directly-written insurance and indemnity reinsurance, has consistently been required by NAIC accounting. In fact, from 1951 through 1974, all commissions incurred in issuing insurance were reported on the same line in the Annual Statement (line 21, page 4). It was not until 1975 that the NAIC first required life insurance companies to report commissions on directly-written insurance and on indemnity reinsurance on separate lines of the Annual Statement (line 21, page 4 and line 21A, page 4, respectively).

[41] In contrast, as is made clear in Treas. Reg. § 1.817-4(d)(2)(ii), Part I of Subchapter L treats assumption reinsurance as the acquisition of insurance policies and requires that the commissions incurred by the assuming company in an assumption reinsurance transaction be capitalized and deducted over the estimated life of such acquired insurance policies, regardless of the treatment prescribed by NAIC accounting for such commissions.

known as indemnity reinsurance. *Merit Life*, 853 F.2d at 1444. Nor do accrual accounting rules address the character, as a currently deductible expense or as an amortizable capital expenditure, of the commissions and other expenses a life insurance company incurs in issuing directly-written insurance. Accordingly, since accrual accounting rules do not require a result contrary to (and are not inconsistent with) NAIC accounting, section 818(a) requires NAIC accounting to control for federal tax purposes.[42] *See Standard Life*, 433 U.S. at 158-59,

[42] This was recently confirmed in a report prepared by the staff of the Joint Committee on Taxation, in conjunction with the staff of the House Committee on Ways and Means, which described possible options for increasing revenues. In proposing as one possible option the requirement that agents' commissions no longer be deducted currently but be capitalized and amortized over the period of coverage under the insurance policy (or, alternatively, over some other fixed period of years), the staffs noted that, to implement such an option, it would be necessary to amend present tax law which mandates that NAIC Annual Statement accounting be followed. Thus, the report states:

> Under present law, a life insurance company generally computes its tax liability by using the accrual method of accounting, or (to the extent permitted in regulations) by using a combination of the accrual method with another method (but not the cash method). All computations, however, to the extent not inconsistent with Federal tax accounting rules, are made in a manner consistent with the manner required for accounting on the annual statement approved by the National Association of Insurance Commissioners ("NAIC"). *Consistent with the annual statement reporting requirements, life insurance companies generally deduct agents' commissions when paid.* (Emphasis added.)

Staff of the Joint Comm. on Taxation, in conjunction with the Staff of the House Comm. on Ways and Means, 99th Cong., 1st Sess. 238, Description of Possible Options to Increase Revenues Prepared for the Comm. on Ways and Means (Comm. Print 1987).

162. NAIC accounting requires the current deduction of ceding commissions incurred in connection with issuing indemnity reinsurance.

This Court should give effect to the NAIC accounting on which Congress based the taxation of life insurance companies and should hold, as the Tax Court and the Seventh Circuit have held, that expenses incurred in the issuance of indemnity reinsurance, like expenses incurred in issuing directly-written insurance, are currently deductible.

CONCLUSION

The judgment of the court of appeals should be reversed and the case should be remanded with instructions to affirm the Tax Court's judgment.

Respectfully submitted,

MARGARET MILNER RICHARDSON
(Counsel of Record)
CAROLYN P. CHIECHI
FRANCIS M. GREGORY, JR.
SUTHERLAND, ASBILL & BRENNAN
1275 Pennsylvania Avenue, N.W.
Suite 800
Washington, D.C. 20004-2404
(202) 383-0100
Attorneys for Petitioner

Of Counsel:

JAMES V. HEFFERNAN
GORDON O. PEHRSON, JR.
GEORGE R. ABRAMOWITZ
DOUGLAS N. BECK
SUTHERLAND, ASBILL & BRENNAN

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